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82-1943

No. -

In the Supreme Court of the United States

OCTOBER TERM, 1982

JOSEPH GANN, INC.,
PETITIONER,

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

WILLIAM GABOVITCH
STEVEN A. GABOVITCH *
Suite 500
148 State Street
Boston, MA 02109
(617) 227-9215
Attorneys for Petitioner

* *Counsel of Record*

Blanchard Press, Inc., Boston, Mass.—Law Printers

I

Questions Presented for Review

1. Whether an Income Tax Regulation which has remained in existence for many years and has been applied to reenacted and unchanged statutes, can be deemed to have received congressional approval for its use in a completely new and untested situation?

2. Whether the "first in, first out" (FIFO) method of computing gains from stock sales is a "method of accounting" in the sense used in Section 446 of the Internal Revenue Code?

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COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

Opinions Below

The per curiam opinion of the United States Court of Appeals for the First Circuit is reported at 701 F.2d 3, 51 AFTR 2d 83-458, and is appended hereto as Appendix A. The opinion of the United States Tax Court is reported at 43 T.C.M. (CCH) 682, and is appended hereto as Appendix B.

Jurisdiction

The judgment of the Court of Appeals for the First Circuit was entered on March 1, 1983 and this petition for certiorari was filed within 90 days of that date. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

Statutes and Regulations Involved

Internal Revenue Code of 1954, 26 U.S.C.

SEC. 446 General Rule for Methods of Accounting

(a) General Rule.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) Exceptions.—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

(c) Permissible Methods.—Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

(1) the cash receipts and disbursements method;

(2) an accrual method;

(3) any other method permitted by this chapter; or

(4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary.

(d) Taxpayer Engaged in More Than One Business.—A taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business.

(e) Requirement Respecting Change of Accounting Method.—Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary.

SEC. 1012. Basis of Property—Cost.

The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). The cost of real property shall not include any amount in respect of real property taxes which are treated under section 164(d) as imposed on the taxpayer.

Regulation § 1.446-1(a)(1)

General rule for methods of accounting.

(a) *General rule.* (1) Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term "method of accounting" includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such over-all methods are the cash receipts and disbursements method, an accrual method, combinations of such methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items. These methods of accounting for special items include the accounting treatment prescribed for research and experimental expenditures, soil and water conservation expenditures, depreciation, net operating losses, etc. Except for deviations permitted or required by such special accounting treatment, taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping with his books. For requirement respecting the adoption or change of accounting method, see section 446(e) and paragraph (e) of this section.

Regulation § 1.1012-1(c)(1)

(c) *Sale of stock*—(1) *In general.* If shares of stock in a corporation are sold or transferred by a taxpayer who purchased or acquired lots of stock on different dates or at different prices, and the lot from which the stock was sold or transferred cannot be adequately identified, the stock sold or transferred shall be charged against the earliest of such lots purchased or acquired in order to determine the cost or other basis of such stock, and in order to determine the holding period of such stock for purposes of subchapter P chapter 1 of the Code. If, on the other hand, the lot from which the stock is sold or transferred can be adequately identified, the rule stated in the preceding sentence is not applicable. As to what constitutes "adequate identification", see subparagraphs (2), (3) and (4) of this paragraph.

Statement of the Case

Joseph Gann, Inc. (Gann) is a Massachusetts corporation engaged in the wholesale and retail jewelry business. In 1971 it elected to be taxed pursuant to Subchapter-S of the Internal Revenue Code.

The corporation had since its inception in 1945 accounted for the gains and losses on its holdings in marketable securities by using the average cost method because the cost of the specific shares sold was impossible to identify. The average cost method was used consistently on the taxpayer's books and on its tax returns.

Pursuant to an audit, the Commissioner changed the taxpayer's method of computing stock gains on only one particular investment to the first in, first out (FIFO) method. This caused the "passive investment income" of the taxpayer to increase from 19.06% to 20.87% of its gross receipts in the fiscal year ended October 31, 1973, thus terminating its Subchapter-S election.

As a result of the Commissioner's determination, the petitioner filed a petition with the U.S. Tax Court pursuant to 26 U.S.C. § 7482. The Tax Court upheld the Commissioner on the basis that a) Congress did not intend Section 446 of the Internal Revenue Code to require that the Commissioner show failure to clearly reflect income before changing a taxpayer's method of accounting, b) Section 1012, as modified by Reg. Section 1.1012-1(c)(1), is more specific than Section 446 and thus overrides Section 446, and c) Reg. Section 1012-1(c)(1) has the force and effect of law by virtue of the failure of Congress to change the statute. The Tax Court took the position that both the average cost method and FIFO were methods of accounting.

On appeal to the Court of Appeals for the First Circuit, the court upheld the Tax Court solely on the grounds that a regulation which has gone unchallenged for many years shall be deemed to have received the approval of Congress.

Argument

Point I

This Is a Case of First Impression in Which the United States Court of Appeals for the First Circuit Has Decided an Important Question of Federal Law Which Has Not Been, but Should Be, Settled by This Court.

At first glance, this case appears to be simply a challenge to Reg. Section 1012-1(c)(1). There have been many such challenges before. However the situation in this case is unique, for in no other recorded case has the Commissioner used Section 1012 to change the accounting method of a taxpayer who established that he regularly used such method of accounting in keeping his books.

In the past, this regulation has only been applied where the taxpayer has been informal or lax in his recordkeeping. Thus, all the cases upholding the FIFO rule concern taxpayers who had no books and records or did not have some other regularly used accounting method.

Likewise, in the past when the Commissioner sought to challenge a taxpayer's accounting method, the Commissioner would attempt to show it did not clearly reflect income, as required by Sec. 446.

Now the Commissioner has changed the taxpayer's regularly used method of accounting, not because it fails to meet the statutory requirement of clearly reflecting income, but because it fails to meet the requirements of a regulation which, when applied to the facts in this case, comes in direct conflict with the statute.

Never before has this statute and regulation been brought before the courts to determine which controls. This is an important and novel question of constitutional law and statutory construction which should be heard and resolved by this Court before any injustice results from a further misapplication of the law.

POINT II

CONGRESS CANNOT BE DEEMED TO HAVE GIVEN THE FORCE OF LAW TO THE APPLICATION OF A REGULATION WHEN THAT USE HAS NOT BEEN CHALLENGED IN THE COURTS NOR BROUGHT TO THE ATTENTION OF CONGRESS AS BEING IN DIRECT CONFLICT WITH A SPECIFIC STATUTE.

The court below has pointed out that longstanding regulations which apply to unchanged statutes are deemed to have received Congressional approval. This argument may be true where a regulation is held to interpret a statute in a particular manner and Congress does nothing to overrule the court's interpretation. In such a case Congress may be deemed to have tacitly approved that particular use of the regulation. However, if at a later date the regulation is used to interpret a different statute or is applied to a substantially different set of circumstances, Congress can not be deemed to have approved this use of the regulation. How can they approve a particular use of a regulation when the question has never been brought before them? In the case at bar, the regulation in question has never before been held to override Section 446 of the Code, and Congress thus can not be deemed to have tacitly passed judgment on the issue.

POINT III

THE FIRST IN, FIRST OUT METHOD OF COMPUTING GAINS AND LOSSES FROM SECURITIES SALES IS A "METHOD OF ACCOUNTING" IN THE SENSE USED IN SECTION 446 OF THE INTERNAL REVENUE CODE.

The Commissioner's regulations recognize that "[t]he term 'method of accounting' includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item." Reg. Section 1.446-1(a)(1). Any rule for determining the amount of gain or loss upon the sale of an item

must therefore be a "method of accounting" and thus fall within the purview of Section 446. In accordance with the above regulation, the Tax Court's opinion in the instant case presupposed that the FIFO rule of Reg. Section 1012-1(c)(1) is a method of accounting and thus subject to the provisions of the Code dealing with methods of accounting.

POINT IV

WHERE A STATUTE AND REGULATION CANNOT BE APPLIED HARMONIOUSLY TO A GIVEN SET OF FACTS, THE REGULATION MUST YIELD TO THE STATUTE.

It has long been settled by this Court that when a regulation and *any* statute (not only the one it purports to regulate) are in conflict, the statute must prevail. *U.S.* v. *Cartwright*, 411 U.S. 546, 93 S.Ct. 1713 (1973). It is also a fundamental rule of statutory construction that when two statutes apply to a given situation, they must be applied so as to give effect to both, if possible. *U.S.* v. *Landram*, 118 U.S. 81, 6 S.Ct. 954 (1886). In the case at hand, the regulation prescribing FIFO comes in direct conflict with Section 446 of the Code and therefore must yield. However, even if the FIFO regulation is treated as having the force and effect of law, the regulation must be interpreted so as to harmonize with Section 446. The solution is not to override Section 446 in favor of Section 1012, for they do not on their face conflict, but to find that Reg. Section 1012-1(c)(1) applies to those situations where Section 446 allows the Commissioner to reject the taxpayer's method of accounting. Such a decision would not diminish the powers of either section, and would prevent the curent dilemma of applying Reg. Section 1012-1(c)(1) while completely ignoring the rules of Section 446 which so obviously apply.

Point V

This Court Has Previously Expressed an Interest in the Potential Conflict Between Section 446 of the Internal Revenue Code and Income Tax Regulation 1.1012-1(c)(1).

One of the two landmark cases concerning the FIFO regulation was *Snyder* v. *Commissioner*, 295 U.S. 134, 55 S.Ct. 737 (1935). There the taxpayer tried to specifically identify which shares of stock he had sold. The Court found the taxpayer had not sufficiently identified the shares and thus, by default, applied the FIFO rule. However, the Court was careful to note in footnote 5 on page 141 that an important issue had not been raised:

> "Snyder does not attempt to bring himself within the general rule of Section 41 of the 1928 Act, [the predecessor of Section 446] to the effect that 'net income shall be computed upon the basis of the taxpayer's annual accounting period in accordance with the method of accounting regularly employed in keeping the books of said taxpayer'. Neither does he state that the method he now suggests was followed in his return."

The issue has not since been brought before a court of law. This Court now has an opportunity to resolve the conflict and put to rest this long standing question.

Point VI

Congress Has Expressly Stated Its Desire That Income Tax Provisions Harmonize With Generally Accepted Accounting Principles.

When Section 446 was placed in the 1954 Code, the accompanying Committee Report (excerpt reproduced in Appendix C) recognized that court decisions and rulings had created various differences in computing income for tax and business

purposes. The Committee stated that their aim was to "... bring the income tax provisions of the law into harmony with generally accepted accounting principles..."

In the case at bar, this Court has an opportunity to implement Congress' express desire. By following the statutory scheme which would allow the use of the taxpayer's accounting method unless it fails to clearly reflect income, the Congressional intent of having "cost" for purposes of Section 1012 computed under the taxpayer's method of accounting as per Section 446 would be fulfilled.

Conclusion

This Court should grant certiorari, and the judgment below should be reversed.

Respectfully submitted,

WILLIAM GABOVITCH
STEVEN A. GABOVITCH*
Suite 500
148 State Street
Boston, MA 02109
(617) 227-9215
Attorneys for Petitioner

*Counsel of Record

APPENDIX A

United States Court of Appeals
For the First Circuit

No. 82-1559

JOSEPH GANN, INC.,

PETITIONER, APPELLANT,

v.

COMMISSIONER OF INTERNAL REVENUE,

RESPONDENT, APPELLEE.

APPEAL FROM THE UNITED STATES TAX COURT

[HON. THEODORE TANNENWALD, JR., *Judge*]

Before

COFFIN, *Chief Judge*,

BREYER, *Circuit Judge*, and

SMITH,* *Senior District Judge*.

Steven A. Gabovitch, with whom *William Gabovitch* was on brief, for appellant.

Daniel F. Ross, Attorney, Tax Division, Department of Justice, with whom *Glenn L. Archer, Jr.*, Assistant Attorney General, *Michael L. Paup*, Attorney, Tax Division, Department of Justice, and *Richard Farber*, Attorney, Tax Division, Department of Justice, were on brief, for appellee.

March 1, 1983

PER CURIAM. This appeal challenges a tax Court decision[1] holding that Treasury Regulations Section 1.1012-1(c)(1) (1954 Code) (26 C.F.R.) is a valid regulation and is applicable to this case. The regulation provides that when a taxpayer sells stock without identifying which of several lots, purchased at different times and prices, has been sold, it will be presumed that the stock sold is the stock first acquired.

*Of the District of Montana, sitting by designation.

[1] 43 T.C.M. (CCH) 682.

The corporate taxpayer-appellant stands to lose its favorable Subchapter S status under Section 1372 of the Internal Revenue Code by reason of its "passive investment income" exceeding 20 percent of its gross receipts. This result follows if, in the relevant tax years, its gains from stock sales are computed on the "first in, first out" (FIFO) basis set forth in the above described regulation. Appellant, however, would keep its favorable status allowing it as an entity to escape income tax liability if it were permissible for it to compute gains from stock sales by using as a basis the average cost of all shares acquired. Taxpayer contends that its use of average cost, parallelling its approach in its bookkeeping for its wholesale and retail jewelry business, is its usual "method of accounting" and is thus sanctioned by Section 446 of the Code,[2] there having been no indication that its method did not clearly reflect income. It claims that the regulation relied on by the Commissioner conflicts with Section 446 and is invalid.

Having read the very substantial briefs of the parties, heard oral arguments, and reviewed the comprehensive opinion of the Tax Court, we deem it sufficient for the purposes of this case to rest on the principle that " 'Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law.' " *United States* v. *Correll*, 389 U.S. 299, 305-06 (1967)[3] (quoting *Helvering* v. *Winmill*, 305 U.S. 79, 83 (1938)). It is this principle that appellant in its dogged, even learned argumentation either overlooks or underestimates.

---

[2] Sec. 446 of the Internal Revenue Code of 1954 (26 U.S.C.) provides in relevant part: "(a) Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books . . . ; (b) . . . if the method used does not clearly reflect income, the computation of taxable income shall be made under [a method determined by the Secretary]; (c) [Permissible methods include] (1) the cash receipts and disbursements method; (2) an accrual method; (3) any other method permitted by this chapter; or (4) any combination of the foregoing methods permitted under regulations . . . ."

[3] We note the use of the word "deemed". Actual proof of congressional awareness and approval is not required.

The statute underlying the challenged regulation is 26 U.S.C. § 1012 which states in effect that the basis for determining gain or loss in the disposition of property "shall be the cost of such property". The regulation embodying FIFO dates from 1918, and the "cost as basis" statute from the same era. In short, for over six decades the commission's method of determining cost for sales of stock where records do not permit identification of actual shares sold has been prominently enshrined in the regulation, provoking no effort by the Congress to change this application of its general statutory mandate. It is equally significant that Section 446 has existed for virtually all of the life of the regulation, its closely similar progenitor having been enacted as Ch. 18 § 212(b), 40 Stat. 1064-65, on February 24, 1919.[4] The regulation, therefore, now has, and for at least a half century has had the force of law. *Skinner* v. *Eaton*, 45 F.2d 568, 570 (2d Cir. 1930).

Appellant recognizes in its brief the presence of various "laws mandating that specific methods of accounting be used in certain instances" (Brief at p. 3), citing, *inter alia*, Sec. 447 (Method of Accounting for Corporations Engaged in Farming), Sec. 453 (Installment Method), Sec. 454 (Obligations Issued at a Discount), Sec. 455 (Prepaid Subscription Income), Sec. 471 (Inventories), and Sec. 167 (Depreciation). These, appellant contends, "are the only Congressional authorized exceptions to the general rule of Sec. 446." (Brief at p. 7) In the first place, we are not sure that the regulation in the instant case, adopting FIFO as a way of identifying shares sold when historical fact is unknown, is a "method of accounting" in the sense in which the words are used in Section 446. It cannot be used when the actual cost of shares is known. It is, in the words of Justice Brandeis in *Helvering* v. *Rankin*, 295 U.S. 123, 130 (1935) (quoting with approbation the taxpayer) " 'a useful and reasonable rule for ascertaining what stock was sold in cases

[4] Were this not so, an argument might be made that § 446 should, as Congress' latest word on the subject, be read as a rejection of Section 1.1012-1(c)(1).

where there is no proof. . . .' "[5] In any event, even if the regulation implicates a "method of accounting" in the sense used in Section 446; the regulation survives fully as much as do the statutory sections noted by appellant, for it *is* law by virtue of its age and coexistence with both 26 U.S.C. §§ 446 and 1012.

We see a persuasive parallel in *Helvering* v. *Winmill*, 305 U.S. 79 (1938), in which Article 282, Treasury Regulation 77, which provided that "Commissions paid in purchasing securities are a part of the cost price of such securities", was held to have the effect of law by reason of the legitimizing effect of age and coexistence of unamended or reenacted statutes. It was contended that the statutory provision concerning uncompensated losses should govern. The court noted "[I]f the specific provisions of Article 282 are valid and have the present effect of law, respondent's contention that the commissions are uncompensated losses within the meaning of the general provisions of § 23(e)(1) of the 1932 Act is unavailing." *Id.* n. 9 at 84. In other words a specific regulation that had become law through age and unchanging relevant statutes was not swallowed up by a more general statute, but continued to be as viable as if it had been enacted by Congress.

We dismiss without further discussion appellant's estoppel argument that, in effect, once the Commissioner fails to challenge a taxpayer's treatment of an item in a return, he is forever barred from enforcing the law as he interprets it. *Lincoln Electric Co.* v. *C.I.R.*, 444 F.2d 491, 493 (6th Cir. 1971).

The remaining points asserted merit no discussion.

Affirmed.

[5] That the FIFO regulation is not coterminous with a "method of accounting" is further suggested by recognition that it also serves the purpose of ascertaining if the stock being sold has been held for a sufficient period, for instance, for capital gain or loss provisions to apply. Appellant's average cost method does not address the holding period problem, but would have the cost of even the shares too recently acquired to merit capital gains treatment affect (favorably to taxpayer during an inflationary period) the basis of the stock sold.

United States Court of Appeals
For the First Circuit

No. 82-1559.

JOSEPH GANN, INC.,
PETITIONER, APPELLANT,

v.

COMMISSIONER OF ETERNAL REVENUE,
RESPONDENT, APPELLEE.

JUDGMENT
ENTERED: MARCH 1, 1983

This cause came on to be heard on appeal from the United States Tax Court, and was argued by counsel.

Upon consideration whereof, It is now here ordered, adjudged and decreed as follows:

The decision of the United States Tax Court is affirmed.

By the Court,

(s) _____
Clerk.

OFFICE OF THE CLERK
UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT

DANA H. GALLUP
CLERK

1606 JOHN W. MCCORMACK
POST OFFICE AND COURTHOUSE
BOSTON, MASS. 02109
(617) 223-2888

March 1, 1983

To Counsel:

Re: #82-1559. Joseph Gann, Inc. v. Commissioner of Internal Revenue

Gentlemen:

Enclosed to each of you are a printed copy of the opinion of the Court and typewritten copy of the judgment in this case.

Under paragraph (a) of F.R.A.P. Rule 39, costs are taxable in favor of the appellee who, under paragraph (c) of this Rule, may recover the cost of reproducing his brief, and his share, if any, of the cost of reproduction of the appendix to briefs, provided he files an itemized and verified bill of such costs, with proof of service, by March 15, 1983.

Sincerely yours,
(s)DANA H. GALLUP,
Clerk.

DHG/as
Enclosures

Steven A. Gabovitch
Suite 1121
40 Court St.
Boston, MA 02108

Daniel F. Ross
U.S. Dept. of Justice
Tax Division
Washington, DC 20530

APPENDIX B

T. C. MEMO 1982-104
UNITED STATES TAX COURT

JOSEPH GANN, INC., PETITIONER v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

DOCKET NO. 14244-78. FILED MARCH 1, 1982.

William Gabovitch and *Steven A. Gabovitch*, for the petitioner.
Barry J. Laterman, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

TANNENWALD, *Chief Judge:* Respondent determined the following deficiencies in petitioner's Federal income taxes:

Taxable year ended	*Deficiency*
October 31, 1973	$ 80,766.51
October 31, 1974	138,203.51
October 31, 1975	83,193.72

We must determine whether during the taxable year ended October 31, 1973, petitioner had gross receipts more than 20 percent of which was from passive investment income and, if it did, whether its election to be treated as a small business corporation was terminated for 1973 and the subsequent years.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly.

At the time it filed its petition herein, petitioner's principal place of business was Boston, Massachusetts. For each of the taxable years ended October 31, 1973, October 31, 1974, and October 31, 1975, petitioner filed its Federal income tax returns with the Director, Internal Revenue Service Center, Andover, Massachusetts.

During the years in issue, petitioner was engaged in selling jewelry at both wholesale and retail. Petitioner's issued and outstanding stock was owned by Joseph Gann, his wife, Rae Gann, and their three children, Herbert Gann, Beverly Bavly, and Shirley Saunders. For its taxable year beginning November 1, 1971, petitioner elected pursuant to section 1372[1] to be taxed as a small business (subchapter S) corporation.

From 1966 through 1968, petitioner purchased 2,000 shares of stock in Bearings, Inc. (Bearings), a publicly traded corporation, for $61,383.66. During 1969, the first 3,225 shares of Bearings stock petitioner purchased cost $128,586.76. After these purchases, petitioner bought additional stock of Bearings. On September 11, 1971, Bearings stock split two-for-one. As a result, petitioner's 2,000 and 3,225 shares referred to above became 4,000 and 6,450 shares, respectively. During the taxable year ended October 31, 1973, petitioner sold 4,000 shares of Bearings stock. On November 14, 1973, Bearings stock again split two-for-one and petitioner's 6,450 shares became 12,900 shares. During the taxable year ended October 31, 1974, petitioner sold 12,900 shares of stock in Bearings.

Petitioner utilized the average-cost method to determine its bases in the stock it sold, i.e., the total cost of a particular security was divided by the total number of shares to arrive at a cost per share. At all times relevant hereto, petitioner has consistently used the average-cost method for both book and tax purposes. Under petitioner's method, the average cost of the Bearings shares sold in the taxable years ending October 31, 1973, and October 31, 1974, is $88,428 and $142,545, respectively. Using the average-cost method to compute the bases of the Bearings stock sold, petitioner's "passive investment income," pursuant to section 1372(e)(5), for the taxable year ended October 31, 1973, is 19.06 percent of petitioner's gross receipts.

---

[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue and all references to Rules are to the Tax Court Rules of Practice and Procedure.

Under the first-in, first-out (FIFO) method, the cost bases of the Bearings stock sold by petitioner in the taxable years ended October 31, 1973, and October 31, 1974, are $61,383.66 and $128,586.76, respectively, and petitioner's passive investment income constitutes 20.87 percent of its gross receipts for the taxable year ended October 31, 1973.

OPINION

The parties in this case disagree as to the proper method for determining petitioner's bases in the Bearings stock. Section 1012 states simply that the basis of property is its cost. When a taxpayer acquires shares of the same stock at different prices and sells only some of the shares, the problem arises of establishing the cost of the shares which were sold. Section 1.1012-1(c)(1), Income Tax Regs., provides that, unless the particular lot from which the stock is sold can be adequately identified, "the stock sold or transferred shall be charged against the earliest of such lots purchased or acquired in order to determine the cost." Respondent argues that, since there is no evidence identifying which shares were sold, the regulations mandate that petitioner use FIFO to determine its bases in the shares sold.

Petitioner presents several alternative arguments: (1) section 1.1012-1(c)(1), Income Tax Regs., cannot be applied to petitioner, since respondent has not alleged, as petitioner contends is required by section 446(b), that petitioner's use of average cost does not clearly reflect income; (2) if the 1973 increase in petitioner's passive investment income is spread over three years, as petitioner urges is mandated by section 481(b), petitioner's subchapter S election does not terminate; (3) equitable considerations dictate that we permit petitioner to utilize average cost.

Section 446(a) states the general rule that "taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in

keeping his books." Subsection (b) contains an exception for situations where the taxpayer's method does not clearly reflect income; in those cases the Commissioner may prescribe a method of accounting which does clearly reflect income. "Method of accounting" as used in section 446 includes not only the taxpayer's overall method of accounting (in this case, accrual) but also the accounting treatment of particular items. See section 1.446-1(a)(1), Income Tax Regs. Since the parties have not argued otherwise, we will assume for purposes of discussion that the use of average cost of FIFO to determine basis constitutes a "method of accounting."

Petitioner argues that section 446 evinces the intent of Congress to permit a taxpayer to use any method of accounting as long as it clearly reflects income. Because respondent argues only that the method of accounting used fails to comply with the regulations under section 1012, and not that it fails to clearly reflect income, petitioner contends that respondent has no grounds to require petitioner to change its method of determining basis from average cost to FIFO. In connection with this argument, petitioner states that section 1012 and section 446 read together leave no question as to how a taxpayer is to calculate cost for tax purposes, i.e., by the same method the taxpayer uses for his books. Thus, petitioner argues that the Commissioner's regulation requiring that cost be calculated by FIFO (when the particular lot from which the security is sold cannot be identified) is inconsistent with section 446 and accordingly is invalid.

For the reasons stated below, we disagree with petitioner's contention and hold that, since the particular lot from which the Bearings stock was sold cannot be identified, respondent properly determined the bases of the Bearings stock by the FIFO method.

Initially, we note that petitioner does not contend that section 1.1012-1(c)(1), Income Tax Regs., is invalid because it is unreasonable or inconsistent with section 1012. Granted that

the FIFO rule "is an arbitrary one, and it may effect hardships," *Vawter* v. *Commissioner*, 83 F.2d 11, 13 (10th Cir. 1936), affg. 31 B.T.A. 884 (1934), its adoption does not create a situation where the Commissioner has made an unreasonable choice among the available alternatives. Compare *United States* v. *Cartwright*, 411 U.S. 546, 557 (1973). See also *Fort Howard Paper Co.* v. *Commissioner*, 49 T.C. 275, 286 (1967), where we expressly rejected the concept that "a taxpayer has a right to choose between alternative generally accepted methods of accounting or that respondent may not, under some circumstances, require a taxpayer to accept his determination as to a preferred selection among such alternatives." Cf. *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522 (1979), discussed *infra* at pp. 12-13. The validity of the FIFO regulation "has been recognized and is not open to question," *Vawter* v. *Commissioner*, *supra*; the regulation "provides a useful and reasonable rule for ascertaining what stock was sold in cases where there is no proof, or lack of satisfactory proof, of the fact." *Helvering* v. *Rankin*, 295 U.S. 123, 130 (1935). See also *Snyder* v. *Commissioner*, 295 U.S. 134 (1935).[2]

Petitioner's argument, however, takes a different tack, namely, that the FIFO regulation is invalid because it conflicts with the general rule of section 446(a). We note that the adoption of petitioner's argument would have far reaching consequences. The Commissioner would be unable to apply any regulation (which did more than repeat the words of the Code) to compel a taxpayer to treat an item differently for tax and book purposes without first showing that the taxpayer's method of treating the item did not clearly reflect income. We do not believe that this interpretation of section 446 is mandated by the words of this section nor that this was Congress' intention in enacting section 446.

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[2] The judicial history relating to the FIFO regulation is set forth in detail in *Haynes* v. *Commissioner*, 17 T.C. 772, 778-779 (1951).

Section 446(a) provides a general rule but, in many instances, the statute itself either requires or permits a taxpayer to treat a particular item differently for tax purposes than for book purposes. See, e.g., sections 162(f), 167, 265(2), 453, 456. In other instances, a Code provision explicitly empowers the Commissioner to promulgate regulations which may have the effect of requiring different treatment of an item for tax purposes. See, e.g., sections 471, 611. If the Code requires that a particular item be treated differently for tax purposes than for book purposes, it is not a sufficient answer that the taxpayer's method of accounting for that item clearly reflects income. We believe section 1012 is an example of such a requirement. Congress provided that for tax purposes basis was cost. The Commissioner's regulation interprets this provision. Section 446, stating a general rule, is not controlling when a more specific section, here 1012, is applicable. In short, we are of the opinion that section 446(b) has no application whatsoever to the instant case.

In any event, the FIFO regulation must be upheld if it "implement[s] the congressional mandate in some reasonable manner." *United States* v. *Correll*, 389 U.S. 299, 307 (1967). The FIFO regulation provides a reasonable means of determining the basis of a security sold when the actual cost of the security cannot be determined, see *Helvering* v. *Rankin*, *supra*, and, as previously pointed out, see p. 7, *supra*, its validity has long since been established. Moreover, since the regulation has been in effect almost as long as the income tax itself (it was originally promulgated under the Revenue Act of 1916) and Congress has re-enacted the statutory provision that "basis is cost" without substantial change, we should not declare it invalid in the absence of clear evidence that it is contrary to the Congressional intent. See *Skinner* v. *Eaton*, 45 F.2d 568, 570 (2d Cir. 1930). Such evidence is lacking in this case. Compare *Rowan Cos.* v. *United States*, 452 U.S. 247 (1981).

We have considered the cases relied on by petitioner in support of its argument; they do not lead us to the conclusion that we should not apply FIFO in this case. We recognize that, in upholding the FIFO rule in *Snyder* v. *Commissioner*, *supra*, the Supreme Court mentioned in a footnote that—

> Snyder does not attempt to bring himself within the general rule * * * that "net income shall be computed * * * in accordance with the method of accounting regularly employed in keeping the books of such taxpayer." Neither does he state that the method he now suggests was followed in his return. [295 U.S. at 141 n. 5.]

Contrary to petitioner's assertion, however, we do not read this footnote as implying that the court would have precluded the Commissioner from applying FIFO had the taxpayer shown that he used average cost on his books. Petitioner has not cited, nor has this Court's own research located, any cases permitting basis to be determined by average cost because the taxpayer so determines basis for book purposes. The courts, however, have sustained the use of FIFO over average cost without making any reference as to the method used by the taxpayer in keeping his books. See, e.g., *Skinner* v. *Eaton*, *supra*.

Petitioner argues that in *Huntington Securities Corp.* v. *Busey*, 112 F.2d 368 (6th Cir. 1940), the taxpayer's method of accounting for inventories was upheld because it clearly reflected income even though the taxpayer's method did not comply with any of the three accounting methods specifically required by the regulations. Petitioner argues that, on the authority of *Huntington Securities*, we should uphold its use of average cost since, so petitioner contends, it clearly reflects income. In *Huntington Securities*, however, the court found that the differences between the method used by the taxpayer and that urged by the Commissioner were "unsubstantial." 112 F.2d at 371. This is not true in the instant case. A comparable situation existed in *Madison Gas & Electric Co.* v.

Commissioner, 72 T.C. 521 (1979), also relied upon by petitioner. Nor is our opinion in *Fort Howard Paper Co.* v. *Commissioner*, 49 T.C. 275 (1967), dispositive of the issue before us. In that case, the issue was whether section 263 applied so as to require capitalization of certain expenses. To determine whether section 263 was applicable, we considered section 446. In the present case, there is no question but that section 1012 applies—petitioner's basis is cost. The issue here is interpreting the meaning of "cost" in section 1012. We hold that the regulation under section 1012 validly defines "cost" for the purposes of this case.[3]

Petitioner also cites several cases to support its assertion that the Commissioner cannot change a taxpayer's method of accounting without first alleging that the taxpayer's method does not clearly reflect income. See, e.g., *Photo-Sonics, Inc.* v. *Commissioner*, 357 F.2d 656 (9th Cir. 1966), affg. 42 T.C. 926 (1964); *John Wanamaker Philadelphia, Inc.* v. *United States*, 175 Ct. Cl. 169, 359 F.2d 437 (1966); *Glenn* v. *Kentucky Color & Chemical Co.*, 186 F.2d 975 (6th Cir. 1951). These cases, however, deal with situations where no authority existed in the Code or the regulations, other than sections 446(b), 471, or their predecessors, for respondent's assertion that the taxpayer treat an item differently for tax than for book purposes. With respect to sections 446 and 471, Congress explicitly made relevant the issue of whether the taxpayer's method clearly reflects income. We do not believe those cases require that, when an otherwise valid regulation compels particular treatment of an item for tax purposes, the respondent must allege that the taxpayer's method, in addition to being contrary to the regulations, also fails to clearly reflect income.

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[3] We also note that *Fort Howard Paper Co.* v. *Commissioner*, 49 T.C. 275 (1967), and *Cincinnati, N.O. & Tex. Pac. Ry.* v. *United States*, 191 Ct. Cl. 572, 424 F.2d 563 (1970) (which involved a similar interplay between sections 162, 263, and 446 and offer some support for petitioner's position herein) were decided prior to the Supreme Court's pronouncement in *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522 (1979).

Aside from the fact that we have concluded that section 446(b) has no application to the instant case (see p. 9, *supra*), even if it did, placement of such a burden on the respondent would fly in the face of *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522 (1979). In that case, the taxpayer's write-down of inventory failed to come within the permissible limits of respondent's regulations. The taxpayer contended that its write-down practice conformed with generally accepted accounting practices and clearly reflected income, with the result that a presumption was created in its favor, and that consequently the burden shifted to respondent to overcome the presumption and to show that its write-down did not clearly reflect income. The Supreme Court flatly rejected any such presumption and further stated that even if such a presumption had been found to exist, it would have to yield in the face of the contrary position embodied in respondent's regulations. See 439 U.S. at 540-544. While we recognize that the broad authority of the Commissioner with respect to inventories by virtue of section 471 can be a basis for distinguishing *Thor Power Tool*, we think such a distinction may be more theoretical than real and that, even if section 446(b) were applicable herein, the teachings of *Thor Power Tool* would clearly be in point.

We conclude that petitioner's bases in the Bearings stock are properly determined by FIFO. The parties have stipulated that, if FIFO is used to compute the cost of the Bearings stock, "passive investment income" constituted 20.87 percent of petitioner's gross receipts in the taxable year ended October 31, 1973. Accordingly, respondent asserts that, pursuant to section 1372(e)(5), petitioner's subchapter S election terminated for that year and for the taxable years subsequent thereto.[4] Peti-

[4] Section 1372(e)(5) provides in pertinent part as follows:

> (A) Except as provided in subparagraph (B) [an exception not applicable here], an election under subsection (a) made by a small business corporation shall terminate if, for any taxable year of the corporation for which the election is in effect, such corporation has gross

tioner, however, argues that if, as section 481(b) requires, the increase in taxable income for 1973 resulting from an accounting method change is spread over 1973 and the previous two years, then the 20-percent passive investment income test has not been violated.

Even were section 481(b) applicable to this case,[5] petitioner misinterprets its effect. Section 481(b) provides that, when a taxpayer's method of accounting is changed and certain requirements are fulfilled, the tax attributable to such increase in taxable income shall not exceed the tax which would have resulted if the adjustment had been included ratably in the taxable income for the year of the change and the two preceding years. Section 481(b) applies only to the amount of tax imposed on a given amount of taxable income; it does not affect the amount of the income itself. Thus, section 481(b) does not prevent the termination of petitioner's subchapter S election.

Petitioner argues that, even if we decide that section 481(b) does not prevent the termination of its election, it is entitled to the benefits of section 481(b) in computing its tax for the year

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receipts more than 20 percent of which is passive investment income. Such termination shall be effective for the taxable year of the corporation in which it has gross receipts of such amount, and for all succeeding taxable years of the corporation.

* * *

(C) For purposes of this paragraph, the term "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains therefrom). Gross receipts derived from sales or exchanges of stock or securities for purposes of this paragraph shall not include amounts received by an electing small business corporation which are treated under section 331 (relating to corporate liquidations) as payments in exchange for stock where the electing small business corporation owned more than 50 percent of each class of the stock of the liquidating corporation.

[5] Here again we assume that a "method of accounting" is involved. See p. 6, *supra*.

ended October 31, 1973. Section 481(b) requires (1) that the method of accounting from which the change is made was used by the taxpayer for the previous two taxable years in computing his taxable income and (2) that the increase in taxable income for the year of the change which results by reason of the adjustments required by section 481(a)(2) exceeds $3,000. Petitioner is not entitled to the benefits of section 481(b) because it has not shown that its taxable income in 1973 as determined by respondent includes adjustments in excess of $3,000 "which are determined to be necessary *solely by reason of the change* in order to prevent amounts from being *duplicated or omitted.*" (Emphasis added.) See section 481(a)(2). Admittedly, petitioner's taxable income for 1973 as determined by respondent differs by more than $3,000 from the taxable income as reported by petitioner. This difference, however, is not attributable to adjustments necessitated solely by a change in accounting method to prevent amounts from being duplicated or omitted. The increase in petitioner's 1973 taxable income is solely attributable to respondent's use of FIFO for securities sold in 1973; it is not attributable to adjustments necessitated by petitioner's use of the average-cost method in previous years and therefore does not involve the "treatment of a recurring material item" as to those securities. See and compare *Electric & Neon, Inc.* v. *Commissioner*, 56 T.C. 1324, 1336-1338 (1971), affd. without published opinion 496 F.2d 876 (5th Cir. 1974).

Finally, petitioner appeals to this Court's equity powers. Petitioner argues that respondent has acted unfairly in disallowing use of the average-cost method for only one security in the taxable year ended October 31, 1974,[6] and in not challenging the use of the average-cost method on prior

[6] Petitioner asserts that respondent acted unfairly in challenging its method for computing cost on only one of twelve sales in 1974. Since petitioner admits, however, that its deficiency would be increased were its basis for the remaining eleven sales determined by the FIFO method, we do not think petitioner has reason to complain.

audits of petitioner and its shareholder, Joseph Gann. Petitioner's accountant testified that previously audited returns contained gains and losses on the sale of securities with cost determined by the average-cost method and that respondent had not questioned the determination of those gains or losses.

In essence, petitioner asks us to apply the doctrine of equitable estoppel, something we have pointed out should be done only with the "utmost caution and restraint." See *Estate of Emerson* v. *Commissioner*, 67 T.C. 612, 617 (1977). In *Union Equity Cooperative Exchange* v. *Commissioner*, 58 T.C. 397 (1972), affd. 481 F.2d 812 (10th Cir. 1973), we made short shrift of arguments practically identical to those made by petitioner herein, stating, "The short and complete answer to petitioner's plea is that it is well established that the Commissioner is not estopped from challenging erroneously reported items where its agents have failed, in prior taxable years, to challenge similar erroneously reported items." 58 T.C. at 408. See also *Automobile Club* v. *Commissioner*, 353 U.S. 180, 183-184 (1957); *Madison Gas & Electric Co.* v. *Commissioner*, 72 T.C. at 554.[7]

In sum, we uphold respondent's determination for each of the years in issue. In the absence of identification of the lot from which the security sales were made, petitioner's bases in the Bearings stock are properly determined by FIFO as prescribed by section 1.1012-1(c)(1), Income Tax Regs. Pursuant to section 1372(e)(5), Income Tax Regs., petitioner's election to be treated as a small business corporation is terminated for the taxable year ended October 31, 1973, and subsequent taxable years.

Decision will be entered for the respondent.

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[7] In *Fort Howard Paper Co.* v. *Commissioner*, 49 T.C. 275, 286 (1967), we emphasized that the method of accounting utilized by the taxpayer had "been frequently applied by respondent in making adjustments to the taxable income of the same taxpayer (*as distinguished from respondent's mere failure to object to the use by such taxpayer*)" (emphasis supplied) and even then utilized such activism by respondent as only one element to be taken into account.

APPENDIX C

SECTION 446 COMMITTEE REPORT

House Report No. 1337, Report of the Committee on Ways and Means, House of Representatives, to accompany H.R. 8300, Page 48.

Committee Report

.20 [General statement.] Present law provides that the net income of a taxpayer shall be computed in accordance with the method of accounting regularly employed by the taxpayer, if such method clearly reflects the income, and the regulations state that approved standard methods of accounting will ordinarily be regarded as clearly reflecting taxable income. Nevertheless, as a result of court decisions and rulings, there have developed many divergencies between the computation of income for tax purposes and income for business purposes as computed under generally accepted accounting principles. The areas of difference are confined almost entirely to questions of when certain types of revenue and expenses should be taken into account in arriving at net income.

The changes embodied in the House bill and in your committee's bill are designed to bring the income-tax provisions of the law into harmony with generally accepted accounting principles, and to assure that all items of income and deductions are to be taken into account once, but only once in the computation of taxable income.